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BookReview

"Trend Following" Is No Panacea

Covel Covers Old Ground, Leaves Key Question Unanswered

Editor's Note: I am often sent investment books, more than any sane woman could possibly read. Only a few, happily, appear to deserve more than a cursory look. Those, however, easily bring on the guilts. Case in point: Michael Covel's recently published "Trend Following." Its bold cover promises to reveal how great traders make fortunes in good markets and bad. How could I not read that? But when would I have time to do it justice? That's when inspiration struck and I prevailed on someone much better qualified than I to assess the book's virtues, one of my Weeden partners, consummate trading pro and closet intellectual Peter Deoteris. His piquant analysis follows—KMW

As market analysis books go, Michael Covel's recently-published, "Trend Following, How Great Traders Make Millions in Up or Down Markets," is not an especially difficult read. And there undoubtedly are newbie or casual students of the market who will find his stories about some of the successful traders he profiles interesting.

Professional traders and serious market followers, however, are likely to find, as I did, that Covel's anecdotes and the philosophies of the "billionaire traders" he recounts are entirely too reminiscent of earlier market books. I am thinking, in particular, of Jack D. Schwager's "Market Wizards," first published more than 15 years ago.

Covel is clearly enamored of a couple of commodities traders in particular. So many of his stories and quotes came from John Henry and Ed Seykota, as well as from their assistants and colleagues. His faith in their "trend following" systems becomes almost evangelical at points, though. Indeed, it seems he takes every word from their lips as gospel, and at times the book degrades into a paean to their successes. John Henry, in particular, clearly impresses the author, though it's not at all clear that Henry's trading acumen is the principal reason for Covel's adoration. Baseball seems a more likely explanation. Covel, the book's jacket notes, is "a lifelong baseball fan. Henry, of course, is the owner of the Red Sox. Covel even goes so far as to compare Henry's strict trading system to the baseball system described in the 2003 bestseller, "Moneyball" a strict, non-human interactive, rating system employed by Oakland A's general manager, Billy Beane.

Other successful traders are quoted and profiled by Covel, however, including Richard Dennis, Bill and Daniel Dunn, Richard Neiderhoffer and Jerry Parker.

The book's main value, it seems to me, resides in the way it highlights the apparent contradictions inherent in the personalities and skill sets of all top traders, regardless of the system they use. A good trader must be a risk-taker, willing to take a bigger than normal position when he feels he is correct--yet he must also be disciplined enough to recognize and take losses quickly. The traders in the book speak of being right in only 40% of their trades, but allowing their profits to ride, and to overcome the 60% that are losses or breakeven. A good trader can differentiate volatility from risk, when by definition they can be synonymous. Traders must have passion for their market, but must also have the patience not to trade. Covel cites several personal histories illustrating that wives, children and normal lives frequently don't mesh well, if at all, with devotion to the market. Yet his stories also demonstrate that top traders need stability and discipline in their everyday lives. You must be informed about every event potentially affecting your market, yet never too emotional or too quick to react to news. Intelligence is paramount but "emotional intelligence" is even more important. Decisions should be emphatic and quickly made, usually relying on first instinct. But the fewer decisions, the better (Occam's razor).

One eye-catching part of the book is Covel's theory that significant world events were all foreshadowed in the markets, and essentially, therefore, were profit opportunities. The Asian debt collapse, the Long-Term Capital Management debacle, the 9/11 terrorist disaster, etc., he maintains were all predicted in some fashion by some super wizards. What's more, since he believes trading is a zero-sum game, Covel asserts they were all profitable for someone. The traders profiled clearly granted Covel unusually extensive access to trading performance records, and so the book is illustrated with numerous tables "demonstrating" his guys' impressive performance in times of crisis. While there is no reason to doubt that Covel accurately reports the statistics he was given, there clearly is a strong element of revisionist history at work here. Covel is looking back and using subsequent events to justify various traders' positions. When those positions were established, however, they were based on logic and assumed risks that were often entirely different.

The book's central conceit is the supposed superiority of the trading system Covel calls "trend following," which is contrary to much of traditional investment theory. A trend-following system encourages the trader to enter a market at breakout points, buying positions only after a breakthrough to a new high, and selling them after a commodity, bond, or stock breaks down to a new low. The stark contrast to the traditional advice to "buy low, sell high" couldn't be more obvious. Covel quotes one of Paul Tudor Jones' famous maxims, "Losers average losers," to bolster his argument. But trend-following theory essentially rests on the assumption that any set of fundamentals strong enough to create a defined movement in a security will lead to a prolonged period of advances or declines in that security-and, therefore, that there's greater potential for profit in capturing the majority of a defined trend than there is in attempting to guess when it will reverse.

The John Henry simplification of this theory recounted in Covel's tome involves the way that the Fed has historically handled changes in the Fed Funs rate. In other words, that the pattern has always been "raise, raise, raise, raise" or "lower, lower, lower, lower." But never "raise, raise, lower, raise, lower." In a purely academic sense, trend trading makes enormous sense. That's because a confident and competent trader is assumed to let profits run while identifying a misread of the trend quickly enough to cut losses long before they become overwhelming. Experience informs, however, that in practice that is one whale of an assumption.

And that, alas, is the core issue that Covel's book fails utterly to address, at least to this trader's satisfaction. Just what is it-in terms of length or breadth or any other definable variable--that differentiates a trend worthy of following from any of any of the myriad of just normal trading fluctuations a trader encounters daily? This omission is especially irritating because the author is constantly quoting dictums from the "wizards" he interviewed to the effect that it's crucial to resist the temptation to be in the market at all times. Their first commandment, it seems, is "Thou shalt enter and exit positions only a few times a year, when trends become evident."

Nice work if you can get it. But you know where I am 60 hours a week!

Don't get me wrong, as an investment read, "Trend Following" is not at all horrible. The casual investor may even find it fantastically revelatory. I just hope our institutional clients know better.

Senior trader Peter Deoteris is one of the maestros who work market magic on Weeden's trading desk.

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